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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 517

WALTER M. HORT, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 19) is reported in 39 B. T. A. 922. The *per curiam* opinion of the Circuit Court of Appeals (R. 71) is reported in 112 F. (2d) 167.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 12, 1940 (R. 72). Upon the application of the petitioner this Court extended

the time within which a petition for a writ of certiorari might be filed for a period of sixty days from August 24, 1940 (R. 75). The petition for a writ of certiorari was filed on October 18, 1940, and granted November 25, 1940, limited to the first question presented in the petition (R. 75). The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

Petitioner owned improved real estate upon a portion of which there was a long-term lease. During the tax year, he agreed to cancel the lease in return for the payment to him of $140,000. The questions are:

1. Whether, upon cancellation of the lease, petitioner realized taxable income in the amount of $140,000, or whether in computing the amount of gain or loss realized, there is to be offset against the $140,000 an amount equal to the value of the lease cancelled, or some other amount representing a capital investment in the lease.

2. If cancellation of the lease resulted in taxable income to petitioner in the amount of $140,000, whether petitioner is entitled to deduct as a loss under Section 23 (e) of the Revenue Act of 1932 an amount equal to the difference, if any, between the value of the lease cancelled and the consideration received for its cancellation.

STATUTE INVOLVED

The pertinent provisions of the Revenue Act of 1932, c. 209, 47 Stat. 169, appear in the Appendix, *infra*, pp. 28–30.

STATEMENT

The facts, as stipulated by the parties (R. 34–37) and as found by the Board of Tax Appeals (R. 21–22), may be summarized as follows:

Petitioner acquired by bequest from his father, who died in March 1928, certain real estate located on Madison Avenue in New York City. The real estate was improved with a ten-story commercial and office building. At the time of the father's death in 1928, the entire building was subject to a lease to Blum & Koch, which was to run until February 1, 1932. Blum & Koch, in turn, had sublet the main floor of the building to the Irving Trust Company, a substantial and financially responsible banking institution. The Irving Trust Company, desiring assurance that it would have possession of the premises beyond 1932, the date of the expiration of the lease to Blum & Koch, entered into a contract with petitioner's father in August 1927, whereby it leased the main floor and basement of the building from him for a term of fifteen years, to commence February 1, 1932, at an annual rental of $25,000 (R. 35, 21–22).

Petitioner, as executor of his father's estate, filed an estate tax return in which he reported the Madison Avenue property as having a fair market value of $650,000. This value was based upon an

appraisal of the property made by appraisers engaged by petitioner, as executor, in which the fair value of the property was set forth as follows: "Land and Building . . . $650,000.00." The estate tax was computed and paid on the basis of a $650,000 valuation for the property (R. 35–36, 21–22).

In June 1933 the Irving Trust Company discontinued the branch office which it had maintained in the building. It then sought to sublease the premises which it had occupied but, because of an unfavorable change in the character of the neighborhood, it was unable to find a subtenant willing to pay a rental of even $10,000 a year. It then negotiated with petitioner for cancellation of the lease, which still had over thirteen years to run. An agreement was reached whereby the lease was cancelled as of December 1, 1933, in return for a payment to petitioner on that date of $140,000. Petitioner lost the property through foreclosure in 1935 (R. 21–22, 36–37).

In his income tax return for the year 1933, petitioner reported a loss of $21,494.75 as a result of the cancellation of the lease,[1] but did not claim that amount as a deduction because other alleged capital

[1] Petitioner computed his alleged loss as follows: The rental payments due under the lease during the remainder of the term, discounted at 4 percent, have a present value of approximately $257,000. The estimated rentals, less brokerage fees, which the premises might be expected to bring for the period covered by the lease amount to approximately $96,000. Thus the value of the lease is computed

losses exceeded the gross income reported (R. 22, 37). The Commissioner determined that the $140,000 received by petitioner constituted income for the year 1933 and assessed a deficiency accordingly (R. 10–15). His action was approved by the Board of Tax Appeals (R. 22–26), and the court below affirmed (R. 72).

SUMMARY OF ARGUMENT

1. The consideration received by the petitioner for cancellation of the lease was income in its entirety. The lease cancelled was not a capital asset of the taxpayer; his capital consisted of the land and building, and the lease was merely a contractual right to receive, as income, fixed rentals for the use of a portion of the land and building. The consideration received for the cancellation of such a contractual right to receive future income is itself income in the year of its receipt. The payment here was made in substitution for the rents originally contemplated and stands in lieu of those rents; since the rents would have constituted income in their entirety, the payment made in lieu of those rents must likewise constitute income in its entirety.

2. Petitioner's contention to the contrary seems to be based primarily on the thesis that the cancellation of the lease constituted a disposition of

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to be $161,000 greater than the rental value of the premises. From this $161,000 petitioner deducted the cash payment of $140,000, leaving a net loss of approximately $21,000 (R. 6–7, 22).

property and that whether gain or loss resulted from the disposition is to be determined by comparing the value of the property disposed of with the price received for it. But it is clear that the determinative factor in computing gain or loss upon the disposition of property for income tax purposes is not the value of the property, as petitioner assumes, but the tax basis, cost or otherwise, of that property. The question here, then, is whether the lease cancelled during the tax year had any tax basis which is to be offset against the $140,000 received for its cancellation.

This question is not answered by mere assertion of the proposition that the lease is property; not all property has a tax basis which is to be offset against the consideration received for the property in determining gain or loss for income-tax purposes. It is only upon the disposition of property which, under the accounting system employed by the taxpayer, may properly be regarded as capital that the money received in exchange for the property is taxable other than as income in its entirety. Stated otherwise, property which is not a capital asset upon its acquisition by the taxpayer and which has not been transmuted into capital by passing through the door of income, has a basis of zero for purposes of determining gain or loss upon its disposition.

Leases may or may not, depending upon the circumstances of each case, be property which is to be considered as capital in the hands of the taxpayer.

A taxpayer who paid $100,000 for an assignment of the lessor's interest in a lease would have a capital investment of $100,000 in that lease; if it were cancelled the next day in return for a payment by the lessee of $100,000, the taxpayer would obviously have realized no gain. On the other hand, if a taxpayer makes a lease on his own property one day and several days later agrees to cancel the lease, or assigns the lease, in return for the payment to him of $100,000, he obviously realizes income of $100,000 because the lease does not represent capital in his hands. He has not spent anything to acquire the lease and the rental obligation cancelled or assigned has not been received and reported as income by him.

The present case must be decided in the light of these principles. The taxpayer may prevail only if he can show that the cancelled lease was property which, in his hands, represented capital. This showing he cannot make. The lease was plainly not capital in the hands of petitioner's father, and it was not transmuted into capital upon the father's death in 1928. The record does not show whether in 1928 the lease had any value; whatever value it might have had was not reported separately in the estate-tax return but was simply reflected as part of the $650,000 valuation placed upon the land and building. Thereafter the tax basis of the property in the hands of petitioner was $650,000; for purposes of income-tax accounting, however, that tax

basis is ascribed entirely to the land and building, which alone are considered as capital assets, the leases being treated as purely income items with a tax basis of zero.

Furthermore, petitioner has failed to show that in 1928 the Irving Trust Company lease, to commence in 1932, was of any value at all. Consequently, even if the lease be treated as a capital asset, it would still be property with a tax basis of zero and its disposition would therefore still result in gain to the full extent of the consideration received.

3. Petitioner also apparently urges that even if the cancellation of the lease resulted in a taxable gain of $140,000, petitioner should still be allowed to deduct as a loss under Section 23 (e) the difference between the value of the lease and the amount of the consideration received for its cancellation. The contention is without merit.

In order for petitioner to establish a deductible loss, he must prove either (a) that he disposed of property for an amount less than the tax basis of the property, or (b) that property which he retained became worthless during the tax year. The discussion above demonstrates that the cancellation of the lease did not constitute a disposition of property for less than its tax basis; a sale or other disposition of property which results in the realization of taxable gain cannot, by definition, result at the same time in a deductible loss. And the

lease was clearly not an asset retained by the taxpayer which became worthless during the tax year. The lease was neither retained by the taxpayer nor did it become worthless; it was cancelled in return for the payment of $140,000. At most, the taxpayer suffered a reduction in the rental value of the land and building which he continued to own. Such a depreciation in value does not constitute the realization of loss.

ARGUMENT

THE COMMISSIONER CORRECTLY DETERMINED THAT, UPON CANCELLATION OF THE LEASE, PETITIONER REALIZED INCOME IN THE AMOUNT OF $140,000

1. THE CONSIDERATION RECEIVED BY PETITIONER UPON CANCELLATION OF THE LEASE IS INCOME IN ITS ENTIRETY

At the beginning of the tax year, petitioner owned certain land and a building, a portion of which was subject to a lease to the bank. During the tax year, he agreed to cancel the lease to the bank in return for the payment of $140,000; he retained, however, the land and building and, presumably, leases on other portions of the building. He did not dispose of the land and building until 1935, when he lost the property at foreclosure sale.

In these circumstances, we believe it entirely clear that the consideration received by the petitioner for cancellation of the lease is income in its entirety. *Josey* v. *Commissioner,* 104 F. (2d) 453 (C. C. A. 10th); *Warren Service Corp.* v. *Commissioner,* 110 F. (2d) 723 (C. C. A. 2d); *Goerke*

Co. v. *Commissioner,* 7 B. T. A. 860; cf. *Taylor* v. *Commissioner,* 51 F. (2d) 915 (C. C. A. 3d); *Merckens* v. *Commissioner,* 7 B. T. A. 32; *Farrelly-Walsh, Inc.* v. *Commissioner,* 13 B. T. A. 923; Paul and Mertens, *Law of Federal Income Taxation,* Vol. 1, § 7.49. The lease cancelled was not a capital asset of the taxpayer; his capital consisted of the land and building, and the lease was merely a contractual right to receive, as income, fixed rentals to be paid by the bank for use of a part of the land and building. The consideration received for the cancellation of such a contractual right to receive future income is itself income in the year of its receipt. *Taylor* v. *Commissioner, supra; Goerke Co.* v. *Commissioner, supra; Merckens* v. *Commissioner, supra;* Paul and Mertens, *loc. cit. supra.*

It is not disputed that if the lease had continued according to its terms, the rental payments would have constituted income in their entirety to the petitioner. And it is similarly not disputed that expiration of the lease would not have affected the amount of petitioner's capital interest in the property as a whole. Since the rental payments would have constituted income and not a return of capital and since, upon expiration of the lease, petitioner's capital in the property would have been the same as it was upon commencement of the lease (except for depreciation), it is manifest that the rental obligation contained in the lease did not constitute a

capital asset. Accordingly, any payments received by petitioner in satisfaction of that obligation or as consideration for its cancellation must constitute income rather than a return of capital.

Stated otherwise, a payment in cancellation of an existing lease is made in substitution for the rent originally contemplated and stands in lieu of that rent;[2] if, as here, the rent would constitute income in its entirety when received, the payment made in lieu of rent must likewise constitute income in its entirety. In both cases, a rental obligation is relinquished in return for a sum of money; if the value of the obligation relinquished may not be deducted from the amount received in the one case (as it clearly may not be in the case of the receipt of rent), it may not be so deducted in the other case.

The fact, stressed by petitioner, that a contractual right to receive future income constitutes property is not relevant. If that right does not represent a capital investment by the taxpayer it does not constitute the type of property which is to be taken into consideration for income-tax purposes. The holder of a coupon bond who cashes an interest coupon realizes income in the amount of the interest payment, without any deduction for the value of the income right relinquished in order to

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[2] See Paul and Mertens, *Law of Federal Income Taxation*, Vol. 1, § 7.49; Magill, *When Is Income Realized*, 46 Harv. L. Rev. 933, 944.

receive the payment. Similarly, a lessor who relinquishes the right to rent in return for a rental payment realizes income in the amount of the rent without any deduction for the value of the right relinquished. And so, too, a lessor such as petitioner who relinquishes, by cancellation, a number of rental obligations in return for the payment of an agreed sum realizes income in the amount of the sum received without any deduction for the value of the obligations cancelled. In each case, the right to receive income which is relinquished, although a property right, is not property which may properly be treated as capital in the hands of the owner. Accordingly, money received upon disposition or relinquishment of the right cannot be considered as a return of capital but must be treated as income in its entirety.

2. PETITIONER'S CONTENTIONS

Petitioner, frankly admitting (Br. 19) that "there may be difficulty in finding a particular tax statute or rule" to support his contentions, seems to advance two different theories to avoid the force of our position. First, he apparently urges that the cancellation of the lease constituted a disposition of property and that by virtue of that disposition he suffered a loss rather than realizing a gain. Second, he apparently urges that, even if the cancellation of the lease resulted in a gain, he is entitled to deduct as a loss the difference between the value of the lease and the

consideration received for its cancellation. In advancing the first contention, petitioner treats the lease as property which has been disposed of during the tax year; in advancing the second contention, he treats the lease as property owned by him which has become worthless during the tax year. The two theories are thus inconsistent and mutually exclusive. In our view, neither theory is sound.

3. TREATING THE CANCELLATION OF THE LEASE AS A DISPOSITION OF PROPERTY, PETITIONER REALIZED INCOME IN THE AMOUNT OF $140,000

Petitioner's primary thesis seems to be that the cancellation of the lease constituted a disposition of property and that whether gain or loss resulted from the disposition is to be determined by comparing the value of the property disposed of with the price received for it.

The argument reveals a fundamental misconception of the structure of the income-tax law. Even in the case of the sale of property representing a capital investment by the taxpayer, gain or loss is not determined by comparing the value of the property sold with the consideration received for it; Section 111 (a) of the Revenue Act of 1932 specifically provides that "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b), and the loss shall be the excess of such

basis over the amount realized." The determinative factor in computing gain or loss upon the disposition of property, therefore, is not the value of the property, as petitioner assumes, but the tax basis, cost or otherwise, of that property.[3] The question here, then, is whether the lease cancelled during the tax year had any tax basis which is to be offset against the $140,000 received for its cancellation.

This question is not answered by mere assertion of the proposition that the lease is "property." We do not question that proposition; indeed, we affirmatively rely upon it in support of our position in *Maass* v. *Higgins* and *Estate of Abendroth* v. *Commissioner,* Nos. 274 and 510–511, present Term, now under submission. But not all property has a tax basis which is to be offset against the consideration received for the property in determining gain or loss for income-tax purposes. It is only upon the disposition of

[3] Any gain realized upon the cancellation of a lease is taxable as ordinary income rather than as capital gain. Section 111 (a) of the 1932 Act provides the method for computing "the gain from the sale *or other disposition* of property"; that gain is to be treated as a capital gain, however, only if it results from a "sale or exchange" of property held by the taxpayer for more than two years. Section 101 (c) (1) and (8). The Board held in this case (R. 25–26), and petitioner no longer contends to the contrary, that the cancellation of a lease in consideration of a money payment is not a "sale or exchange." Cf. *Fairbanks* v. *United States,* 306 U. S. 436; *Hale* v. *Helvering,* 85 F. (2d) 819 (App. D. C.).

property which, under the accounting system employed by the taxpayer, may properly be regarded as capital that the money received in exchange for the property is taxable other than as income in its entirety. Stated otherwise, property which is not a capital asset upon its acquisition by the taxpayer and which has not been transmuted into capital by passing through the door of income, has a basis of zero for purposes of determining gain or loss upon its disposition.

A few illustrations will make this clear. A taxpayer on March 1, 1913, owns a contested and unliquidated claim for patent infringement. That claim is "property." *Erwin* v. *United States,* 97 U. S. 392, 395–396. Yet, because the claim is "so contingent and indefinite as to lack the quality of accrued income" and therefore cannot be considered as "property that has been transmuted into capital," any amount received by the taxpayer upon compromise of the claim is taxable income in its entirety. *United States* v. *Safety Car Heating Co.,* 297 U. S. 88, 94, 97. If, however, the owner of the claim assigned it after March 1, 1913, in return for a payment of money, the claim would represent a capital investment in the hands of the assignee to the extent of the payment. If the claim were then compromised, the assignee would have to be made whole for that capital investment before he realized any income. Thus, although the character of the claim as "property"

is plainly the same whether the claim be held by the original owner or by the assignee, its treatment for income tax purposes differs depending upon whether or not it is properly to be treated as capital from an income tax accounting standpoint.

Again, we may take the case of a taxpayer who in 1940 receives a note of a corporation representing salary owed to him for services rendered during that year. If the taxpayer is on a cash basis, so that the note is not received and returned as income in 1940, the note, although clearly property, is not property that, by passing through the door of income, has been transmuted into capital. Consequently, if the taxpayer sells the note in 1941, the full amount realized is income, the note being considered as property with a basis of zero. Similarly, if the taxpayer retains the note and the corporation goes into bankruptcy in 1941 before payment, the taxpayer will not be allowed a bad debt deduction. In other words, because the note was never received and reported as income, it never became a capital asset and consequently it is not an operative factor from an income tax accounting standpoint. On the other hand, if the same taxpayer had been on an accrual basis of accounting and had received and reported the note as income for 1940, it would be property transmuted into capital. Such a taxpayer would not derive income from a sale of the note in 1941 and would have a bad debt deduction if he re-

tained the note and the corporation went into bankruptcy in 1941 before payment. See Art. 192, Regulations 77; Paul and Mertens, *Law of Federal Income Taxation,* Vol. 3, § 28.19 and cases cited. And these divergent results are reached despite the fact that the character of the note as "property" is clearly the same in both situations.

The general principle, then, is that property which, under the system of accounting employed by the taxpayer, is not to be treated as "capital" because it was not a capital asset when acquired and was not transmuted into capital by passing through the door of income, is either to be disregarded or else to be regarded as having a basis of zero in determining gain or loss upon disposition of the property.

Leases may or may not, depending upon the circumstances of each case, be property which is to be considered as capital in the hands of the taxpayer. A taxpayer who paid $100,000 for an assignment of the lessor's interest in a lease would have a capital investment of $100,000 in that lease;[4] if it were cancelled the next day in return for a payment by the lessee of $100,000, the taxpayer would obviously have realized no gain. On

[4] Such a taxpayer would be entitled to a return of his capital investment before he realized income from the lease. This would be accomplished by allowing him to take as a deduction in his return an aliquot part of his investment each year, based on the number of years the lease has to run. Art. 130, Regulations 77.

the other hand, if a taxpayer makes a lease on his own property one day, and several days later agrees to cancel the lease in return for a payment to him of $100,000 (or assigns the lease for $100,000), he obviously realizes income of $100,000 because the lease does not represent capital in his hands. He has not spent anything to acquire the lease and the rental obligation cancelled or assigned has not been received and reported as income by him.

The present case must be decided in the light of these principles: the taxpayer may prevail only if he can show that the cancelled lease was property which, in his hands, represented capital. This the record fails to establish. The lease was originally made by petitioner's father in 1927; at that time it was clearly not a capital asset since it represented, not a capital investment, but merely a contractual right to future income from a portion of the land and building which petitioner's father owned. The term of the lease was not to commence until February 1, 1932, almost five years after its execution, when the then existing lease of the entire building to Blum & Koch was to expire.

The lease, not capital in the hands of petitioner's father, did not become transmuted into capital upon the father's death in 1928. The record does not show whether in 1928, the lease had any value; whatever value it might have had was not reported separately in the estate tax return but was simply

reflected as part of the value of the land and building. The land and building, subject to all leases, were reported at a value of $650,000. Under Section 113 (a) (5) of the 1932 Act, that amount represents the tax basis of the property in the hands of petitioner—his capital interest in the property.

Theoretically, it might be urged that this tax basis should be split up and a portion thereof ascribed to each component of value entering into the $650,000, i. e., the land and building, the lease to Blum & Koch, the lease of the first floor and basement to Irving Trust Company on and after February 1, 1932, any similar leases on other portions of the building, etc. Practically, however, the tax basis is, for income tax accounting purposes, ascribed to the land and building alone; a horizontal severance of capital cost into lease and reversionary interest is not permitted. This is shown by the fact that rental payments are considered income in their entirety and not a return of capital, and that the owner's capital investment in the premises is not considered affected by the termination of any leases thereon. See *Farmer* v. *Commissioner,* 1 B. T. A. 711; *Nelson Land & Oil Co.* v. *Commissioner,* 3 B. T. A. 315; *Du Pont* v. *Commissioner,* 18 B. T. A. 1028, 1035. No other theory of income tax accounting would either be feasible or accord with the concepts of capital and income normally employed in the business world. Cf. *Old Colony Railroad Co.* v. *Commissioner,* 284

U. S. 552, 560–561; *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, 3; *United States* v. *Wurts*, 303 U. S. 414, 417. In the case at bar, for example, it would certainly not have been practicable for petitioner, upon his father's death, to have allocated his capital interest separately to the land and building, to the Blum & Koch lease, and to the Irving Trust lease. The only feasible course, and the only course which accords with common usage, is to consider the land and building as the capital asset and the leases as purely income items.

Furthermore, it can scarcely be contended that petitioner, on the present record, has established that in 1928 the lease to the Irving Trust Company, to commence in 1932, had any value whatsoever. Consequently, even if the lease be treated as a capital asset, it would still be property with a tax basis of zero and its disposition would therefore still result in gain to the full extent of the consideration received. Cf. *Josey* v. *Commissioner*, 104 F. (2d) 453 (C. C. A. 10th).

It is clear, therefore, that by whatever theory the question be approached, the Irving Trust lease was not property which, in the hands of the petitioner, had a tax basis to be offset against the $140,000 payment made for its cancellation. Accordingly, the Commissioner correctly determined that the transaction of cancellation gave rise to taxable income in the amount of $140,000.

4. PETITIONER IS NOT ENTITLED TO DEDUCT AS A LOSS THE DIFFERENCE, IF ANY, BETWEEN THE VALUE OF THE LEASE ON THE DATE OF CANCELLATION AND THE CONSIDERATION RECEIVED THEREFOR

Petitioner seems to urge that even if the transaction whereby the lease was cancelled in return for the $140,000 payment be considered as resulting in a taxable gain of $140,000, petitioner should still be allowed to deduct as a loss under Section 23 (e) of the Revenue Act of 1932 the difference between the value of the lease and the amount of the consideration received for its cancellation. The contention is, we submit, without substance.

The income tax law is in general concerned only with realized losses, as with realized gains. *Lucas* v. *American Code Co.*, 280 U. S. 445, 449. A mere reduction in the value of property owned by the taxpayer is not sufficient to entitle him to a deduction; his realization of loss must be evidenced by a closed transaction. *United States* v. *White Dental Co.*, 274 U. S. 398. In order for petitioner to establish a deductible loss in this case, therefore, he must prove either (a) that he disposed of property for an amount less than the tax basis of the property, or (b) that property which he retained became worthless during the tax year.

The discussion in the preceding pages of this brief amply demonstrates that the cancellation of the lease did not constitute a disposition of property for less than its tax basis; a sale or other

disposition of property which results in the realization of taxable gain cannot, by definition, result at the same time in a deductible loss. And, of course, petitioner's entire argument, based as it is on the theory that there was a disposition of the lease, is inconsistent with any contention that the lease constituted an asset retained by the taxpayer which became worthless during the tax year. The lease was neither retained by the taxpayer nor did it become worthless; it was cancelled in return for the payment of $140,000.

If we assume, contrary to apparent fact (see page 26, *infra*), that the cancellation was economically unfavorable to the petitioner, this would mean simply that the rental value of the land and building was reduced by the transaction. But since the petitioner continued to own the land and building throughout the taxable year, the reduction in its value cannot be treated as a realized loss, deductible under Section 23 (e). The loss, if any, would be realized and deductible only in 1935, when the property was sold at foreclosure sale (R. 9). *United States* v. *White Dental Co., supra; Helvering* v. *Hammel,* No. 49, present Term.

It is true that the decision in *Commissioner* v. *Langwell Real Estate Corp.,* 47 F. (2d) 841 (C. C. A. 7th), relied upon by petitioner, does support his position; in our view, however, that decision is patently wrong. There a lessee had made a deposit of $50,000 to secure the faithful

performance of the terms of a lease, the deposit to be returned by the landlord at the termination of the lease. Thereafter the landlord agreed to cancel the lease and the tenant agreed to relinquish all right to return of the deposit. The Commissioner determined that this transaction resulted in income of $50,000 to the landlord, but the Board of Tax Appeals reversed. Upon appeal, the Circuit Court of Appeals for the Seventh Circuit held (1) that upon the tenant's release of his interest in the deposit, the landlord realized income in the amount of $50,000; but (2) that by virtue of the same transaction the landlord could deduct as a loss the difference, if any, between the value of the lease and the rental value of the property. The cause was remanded to the Board to determine whether the landlord had in fact suffered such a loss.[5]

In our view, the *Langwell* decision is erroneous for reasons already stated. The record there showed no disposition of property for less than its tax base and no ascertainment during the tax year that any property retained by the taxpayer had become worthless. Consequently, the taxpayer suffered at most a reduction in the rental value of land and buildings which he continued to own—a depreciation in value which does not constitute the realization of loss. *United States* v. *White Dental*

[5] Upon remand, the Board determined that the taxpayer had not suffered a loss. 30 B. T. A. 145.

Co., supra; Lucas v. *American Code Co., supra.* The contrary decision of the court is based on the utterly untenable premise that a taxpayer may both derive a gain and suffer a loss as the result of the same transaction.

We have found no case in which the *Langwell* decision has been followed. The court below expressly disapproved it in *Warren Service Corp.* v. *Commissioner,* 110 F. (2d) 723, upon the authority of which the present case was decided. The court there stated (p. 724):

> The Board held that the cancellation of that obligation was income to the taxpayer in 1933. Assuming arguendo that this be true, the taxpayer contends that it sustained a loss by reason of the cancellation of the lease which more than offsets such income. It urges that it surrendered a contractual right to receive annual rentals far in excess of any sum for which it has been able to relet the premises. But this does not establish a deductible loss in 1933; it shows merely a diminution of expected income during that year and subsequent years. The taxpayer has sustained no loss of property in the income-tax sense. The land and building were and still are owned by the taxpayer and they have produced income. The difference between the income actually received and the income the taxpayer had expected to receive is not a deductible loss. What has been lost is merely prospective income. See *Josey* v. *Commissioner,* 10 Cir.,

> 104 F. (2d) 453, 455. If the case of *Commissioner* v. *Langwell Real Estate Corp.*, 7 Cir., 47 F. (2d) 841, is to be read as supporting the taxpayer's contention, we must respectfully decline to follow it, as did the Board.

And in *Josey* v. *Commissioner*, 104 F. (2d) 453, the Circuit Court of Appeals for the Tenth Circuit, in discussing a comparable contention made in connection with the cancellation of a sublease, stated (p. 455):

> When the Schulte sublease was cancelled, Josey surrendered a contractual right to receive annual rentals far in excess of what he is now receiving from the premises for a consideration of $10,000. This difference does not constitute a taxable loss since it has never been acquired and reported as income and for tax purposes that which has never been reported as income (unless its gain is nontaxable) has never been acquired. *Tiscornia* v. *Commissioner*, 9 Cir., 95 F. 2d 678, 683. In other words, had Josey continued to receive the rentals under the sublease, he would have had to report them as income. And not having received them, he suffered no deductible loss.

On the basis of these principles, we believe it clear that, even had the petitioner suffered an economic loss by reason of the cancellation of the lease, it would not be a loss which could be re-

flected in his income tax return until disposition of the land and building.

Furthermore, the assumption that petitioner suffered an economic loss is contradicted by the record. Petitioner would have sustained such a loss only if the value of the lease was greater than the consideration received for its cancellation. Since, however, the lessee was a financially responsible institution and, according to the testimony of its own real-estate manager, "could have paid the full $25,000 per year until the term of the lease expired in 1947" (R. 50), there is no reason to suppose that petitioner would have cancelled the lease for less than its full value. Indeed, just as the price at which property is sold is ordinarily the best evidence of the value of that property, so too the consideration agreed upon between landlord and financially responsible tenant for cancellation of a lease is ordinarily the best evidence of the value of that lease. The agreement between petitioner and the Irving Trust Company is therefore persuasive proof that the value of the lease was $140,000, the amount paid for its cancellation. The record contains no proof supporting any other valuation.

We submit, therefore, that under no theory did petitioner suffer a deductible loss which he may offset against the $140,000 taxable income realized upon cancellation of the lease.

CONCLUSION

The decision of the court below should be affirmed.

Respectfully submitted.

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MARCH 1941.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) *General Definition.* "Gross income" includes gains, profits, and income derived from * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * *.

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME:

In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by Individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

* * * * *

SEC. 101. CAPITAL NET GAINS AND LOSSES.

* * * * *

(c) *Definitions.*—For the purpose of this title—

(1) "Capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b), and the loss shall be the excess of such basis over the amount realized.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(5) *Property transmitted at death.*—If personal property was acquired by specific bequest, or if real property was acquired by general or specific devise or by intestacy, the basis shall be the fair market value of the property at the time of the death of the decedent. If the property was acquired by the decedent's estate from the decedent, the basis in the hands of the estate shall be the fair market value of the property at the time of the death of the decedent. In all other cases if the property was acquired either by will or by intestacy, the basis shall be the fair market value of the property at the time of the distribution to the taxpayer. In the case of property transferred in trust to pay the income for life to or upon the order or

direction of the grantor, with the right reserved to the grantor at all times prior to his death to revoke the trust, the basis of such property in the hands of the persons entitled under the terms of the trust instrument to the property after the grantor's death shall, after such death, be the same as if the trust instrument had been a will executed on the day of the grantor's death.

* * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

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SUPREME COURT OF THE UNITED STATES.

No. 517.—October Term, 1940.

Walter M. Hort, Petitioner, *vs.* Commissioner of Internal Revenue, Respondent.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[March 31, 1941.]

Mr. Justice Murphy delivered the opinion of the Court.

We must determine whether the amount petitioner received as consideration for cancellation of a lease of realty in New York City was ordinary gross income as defined in § 22(a) of the Revenue Act of 1932 (47 Stat. 169, 178), and whether, in any event, petitioner sustained a loss through cancellation of the lease which is recognized in § 23(e) of the same Act (47 Stat. 169, 180).

Petitioner acquired the property, a lot and ten-story office building, by devise from his father in 1928. At the time he became owner, the premises were leased to a firm which had sublet the main floor to the Irving Trust Co. In 1927, five years before the head lease expired, the Irving Trust Co. and petitioner's father executed a contract in which the latter agreed to lease the main floor and basement to the former for a term of fifteen years at an annual rental of $25,000, the term to commence at the expiration of the head lease.

In 1933, the Irving Trust Co. found it unprofitable to maintain a branch in petitioner's building. After some negotiations, petitioner and the Trust Co. agreed to cancel the lease in consideration of a payment to petitioner of $140,000. Petitioner did not include this amount in gross income in his income tax return for 1933. On the contrary, he reported a loss of $21,494.75 on the theory that the amount he received as consideration for the cancellation was $21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease. He did not deduct this figure, however, because he reported other losses in excess of gross income.

The Commissioner included the entire $140,000 in gross income, disallowed the asserted loss, made certain other adjustments not material here, and assessed a deficiency. The Board of Tax Appeals affirmed. 39 B. T. A. 922. The Circuit Court of Appeals affirmed per curiam on the authority of *Warren Service Corp.* v. *Helvering*, 110 F. (2d) 723. 112 F. (2d) 167. Because of conflict with *Commissioner* v. *Langwell Real Estate Corp.*, 47 F. (2d) 841, we granted certiorari limited to the question whether, "in computing net gain or loss for income tax purposes, a taxpayer [can] offset the value of the lease canceled against the consideration received by him for the cancellation". 311 U. S. —.

Petitioner apparently contends that the amount received for cancellation of the lease was capital rather than ordinary income and that it was therefore subject to §§ 101, 111-113, and 117 (47 Stat. 169, 191, 195-202, 207) which govern capital gains and losses. Further, he argues that even if that amount must be reported as ordinary gross income he sustained a loss which § 23(e) authorizes him to deduct. We cannot agree.

The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. Section 22(a), copied in the margin,[1] expressly defines gross income to include "gains, profits, and income derived from . . . rent, . . . or gains or profits and income from any source whatever". Plainly this definition reached the rent paid prior to cancellation just as it would have embraced subsequent payments if the lease had never been canceled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. Compare *United States* v. *Safety Car Heating Co.*, 297 U. S. 88; *Burnet* v. *Sanford*, 282 U. S. 359. That the amount petitioner received resulted from negotiations ending in cancellation of the

[1] Sec. 22(a). "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

lease rather than from a suit to enforce it cannot alter the fact that basically the payment was merely a substitute for the rent reserved in the lease. So far as the application of § 22(a) is concerned, it is immaterial that petitioner chose to accept an amount less than the strict present value of the unmatured rental payments rather than to engage in litigation, possibly uncertain and expensive.

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property", whatever that signifies abstractly. Presumably the bond in *Helvering* v. *Horst*, 311 U. S. 112, and the lease in *Helvering* v. *Bruun*, 309 U. S. 461, were also "property", but the interest coupon in *Horst* and the building in *Bruun* nevertheless were held to constitute items of gross income. Simply because the lease was "property" the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which § 22(a) expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital".

For the same reasons, that amount was not a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father. Theoretically, it might have been possible in such a case to value realty and lease separately and to label each a capital asset. Compare *Maass* v. *Higgins*, No. 274, decided March 3, 1941; *Appeal of Farmer*, 1 B. T. A. 711. But that would not have converted into capital the amount petitioner received from the Trust Co. since § 22(b)(3)[2] of the 1932 Act (47 Stat. 169, 178) would have required him to include in gross income the rent derived from the property, and that section, like § 22(a), does not distinguish rental payments and a payment which is clearly a substitute for rental payments.

We conclude that petitioner must report as gross income the entire amount received for cancellation of the lease without regard

[2] Sec. 22(b). The following items shall not be included in gross income and shall be exempt from taxation under this title: . . . .

(3) The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income).

to the claimed disparity between that amount and the difference between the present value of the unmatured rental payments and the fair rental value of the property for the unexpired period of the lease. The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but to that extent he was relieved of the duty to pay income tax. Nothing in § 23(e)[3] indicates that Congress intended to allow petitioner to reduce ordinary income actually received and reported by the amount of income he failed to realize. See *Warren Service Corp.* v. *Commissioner, supra; Josey* v. *Commissioner,* 104 F. (2d) 453; *Tiscornia* v. *Commissioner,* 95 F. (2d) 678; *Farrelly-Walsh Inc.* v. *Commissioner,* 13 B. T. A. 923; *Gercke Co.* v. *Commissioner,* 7 B. T. A. 860; *Merckens* v. *Commissioner,* 7 B. T. A. 32. Compare, *United States* v. *Safety Car Heating Co., supra; Voliva* v. *Commissioner,* 36 F. (2d) 212; *Appeal of Denholm,* 2 B. T. A. 444. We may assume that petitioner was injured insofar as the cancellation of the lease affected the value of the realty. But that would become a deductible loss only when its extent had been fixed by a closed transaction. Regulations No. 77, Art. 171, p. 46; *United States* v. *White Dental Mfg. Co.,* 274 U. S. 398.

The judgment of the Circuit Court of Appeals is affirmed.

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[3] Sec. 23(e). Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise [shall be deductible from gross income]—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.